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If We Can't Understand Them, We Should Just Break Them Up

By. Rep. Brad Miller

I've skimmed some informed discussions at economics blogs about how JPMorgan Chase (JPMC) lost $2 billion and counting on their "synthetic credit portfolio." But educated guesses are still guesses, the next big problem in the financial system will be entirely different, and to be honest, it all gives me a headache.

Apparently I'm in good company.

"Paul Volcker by his own admission has said he doesn't understand capital markets," Dimon told Fox Business News earlier this year. "He has proven that to me." Dimon is less polite in private. Dimon reportedly was asked at a dinner for investors about Volcker's criticisms and the arguments by Richard W. Fisher, president of the Federal Reserve Bank of Dallas, that "too big to fail" banks should be broken up. Dimon said he had only two words for Volcker and Fisher: "infantile" and "nonfactual."

Industry lobbyists generally aren't so belligerent when talking to congressmen from the provinces, or at least they don't show it. Volcker and Fisher should know better, but congressmen? No, we suffer -- or benefit -- from the soft bigotry of low expectations. Bank lobbyists explain financial practices to us patiently, speaking slowly and using small words. As bank lobbyists patiently explained finance to me, I resisted the temptation to use expressions like "Shazam!" or "Well, g-o-l-l-y!" made famous by a fictional North Carolinian. When they explained the flaws in the predatory mortgage lending legislation that I first introduced in 2004, they always began with "while this legislation is well-intended... "

When we do pass reform legislation despite our obvious limitations, the law is enforced by regulatory agencies, which also tend to be staffed by mere mortals.

The Volcker Rule limits "proprietary trading" in derivatives by the biggest banks, and regulators may step in when any practice puts the solvency of a bank or the stability of the financial system at risk. Good luck with that. Some examiner is supposed to figure out whether hopelessly complex credit default swaps are impermissible "proprietary trades" or permissible "hedging" or "market-making," and the risks credit default swap positions might create.

Ina Drew, JPMC Chief Investment Officer, made $14 million last year. If she didn't understand the risk in their derivatives positions, then what chance does an examiner on a government salary have?

So trading in derivatives remains lightly regulated, which is more regulation than the repo market has. "Repo" is short for "repurchase agreement." Repo lending is a form of "shadow banking" and it's... well, there's a Wikipedia entry about it. There are $15 trillion in assets in shadow banking, more than the assets of traditional banking. Bear Stearns was borrowing as much $102 billion a day in the repo market to stay in business. What ultimately brought Bear Stearns down was an old-fashioned run in shadow banking, with repo lenders rushing to get their money out.

The biggest banks argue that if the lesser mortals who populate the institutions of democratic government don't understand the intricacies of their business, then we just shouldn't meddle. The laws Congress pass or the rules that regulators adopt may well have "unintended consequences." And if Congress or regulators forbid one practice, they'll just find another way to do the same thing. So really, regulation is just a pointless irritant.

The consequences of not meddling may be unattractive, however.

According to Tyler Cowen, an economist and blogger, the size of shadow banking and of the derivatives markets may create "a need for sudden payouts [that] could also prompt a run on a financial institution." "It now seems that the 21st century will resemble the 19th and early 20th centuries, with periodic panics and runs on financial institutions, perhaps followed by deflationary collapses," Cowen said. An economic recovery "may shove some problems into the future. But banking and finance remain a mess at their core. Welcome to the 21st century."

So how do we avoid this grim future created by financial practices beyond the ken of lesser mortals like congressmen and regulators?

We can just break the biggest banks up. A bank would almost certainly be easier to understand, both for the bank's managers and for safety and soundness regulators, if there is less to understand. And if a smaller bank's management and regulator don't understand a risk in shadow banking or derivative markets, the risk may bring the bank down, but it probably won't lead to a "deflationary collapse" of the economy.

There is little that a $2.3 trillion bank can do that ten $230 billion banks can't do as well or better, and banks the size of JPMC are far more than ten times the problem.

Last week Senator Sherrod Brown and I introduced the SAFE Banking Act to break up the biggest banks into banks that are small enough and simple enough to fail without bringing the financial system down. The biggest banks probably think that's an infantile idea, and that Americans won't support that solution to "too big to fail" banks.

Surprise, surprise, surprise.